



Statement of the  
Association for Financial Professionals  
to the  
U.S. House of Representatives  
Committee on Financial Services  
Subcommittee on Financial Institutions and Consumer Credit  
Representative Spencer Bachus (R-AL), Chairman  
For the Record of the Hearing on  
Check Clearing for the 21<sup>st</sup> Century Act (H.R. 5414)  
September 25, 2002

**STATEMENT OF THE ASSOCIATION FOR FINANCIAL PROFESSIONALS TO THE  
UNITED STATES HOUSE OF REPRESENTATIVES  
COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT  
REPRESENTATIVE SPENCER BACHUS (R-AL), CHAIR  
FOR THE RECORD OF THE HEARING ON  
CHECK CLEARING FOR THE 21<sup>ST</sup> CENTURY ACT (H.R. 5414)  
SEPTEMBER 25, 2002**

Mr. Chairman and members of the Subcommittee on Financial Institutions and Consumer Credit, the Association for Financial Professionals (AFP) welcomes this opportunity to submit a statement for the record of the hearing on the Check Clearing for the 21<sup>st</sup> Century Act (H.R. 5414), held on September 25, 2002.

AFP represents approximately 14,000 treasury and finance professionals who, on behalf of over 5,000 corporations and other organizations, are significant participants in the nation's payments system. Organizations represented by our members are drawn generally from the Fortune 1,000 and the largest middle market companies. Many of AFP's members have direct responsibility for check disbursements, collections, reconciliation, and fund transfers generally. AFP members' companies, with their higher check volume, larger check amounts and greater exposure to fraud, have a sizable interest and significant stake in the advancement of measures to improve the efficiency and safety of the payments system.

AFP has been a strong advocate of the federal government's efforts to migrate from checks to electronic payments. We cooperated with the government to develop and implement the Electronic Federal Tax Payment System that enables businesses to pay their federal tax deposits electronically. We supported EFT 99, the legislative mandate requiring the government to make disbursements electronically. And we actively participated in discussions with the Federal Reserve Board during the drafting of the Check Clearing for the 21<sup>st</sup> Century Act, or Check 21.

Check 21 is designed to foster innovation in the check collection system without mandating the receipt of checks in electronic form. It would do this by removing the legal impediments to check truncation. The bill would permit machine-readable paper copies of checks, called substitute checks, to replace original checks in the clearing and return process. In drafting the law, the Federal Reserve sought to ensure "that a bank and its customer would be in the substantially equivalent legal and practical position regardless of whether or not they received the original check." The proposed legislation would encourage banks to eliminate paper from the check system at the earliest possible point in the process. This would increase the efficiency of the check system, cut costs and improve availability. Given the continued predominance of checks as the primary payment method in the U.S., the resulting increase in productivity should bring substantial benefits to the economy.

AFP supports the concepts underlying Check 21 and understands the benefits of replacing original checks with check images. However, we believe that there are several provisions in the

Act as currently drafted that, if not corrected, would lead to unintended consequences in some cases while allowing other barriers to check truncation to remain standing. They are:

- Linking all duties, obligations, and protections under Check 21 only to items that meet the four-part test of a “substitute check,” while leaving purported substitute checks that suffer from a technical defect in an uncertain legal position.
- Omitting electronic images of checks—digitized reproductions of the original checks—from the scope of the Act, at least for purposes of legal equivalency. Their inclusion under the Act would eliminate uncertainty regarding the acceptability of electronic images in contract disputes where payments are involved and thereby advance the adoption of electronics in check processing.

We will also point out other drafting issues that should be clarified.

### **Linking of Duties, Obligations and Protections Only to “Substitute Checks” as Defined**

We believe that a bank is obligated to ensure that a substitute check qualifies as a “substitute check” under the multi-part test of Section 2(17). When there are defects that prevent an item from meeting the definition of a “substitute check,” a paying bank would be under no obligation to accept it under Section 3(a) and the original check would have to be presented. However, an item may be created and handled with the intention that it be treated as a substitute check, but the item may ultimately suffer from a defect that prevents it from being a “substitute check” under the Act. For example, a bank may have encoded the MICR line sufficiently for the item to be processed, but may have failed to encode “all” of the required MICR line information generally applicable under industry standards as required under Section 2(17)(B).

Such an item would not appear to be afforded the legal equivalency protections of Section 3(b),<sup>1</sup> nor would the warranties and indemnities of Sections 4 and 5 seem to apply under this circumstance because all of these provisions apply literally only to checks that are actual substitute checks as defined. The same is true of the consumer protections in Section 6. Damages may not be recoverable under Section 8 because there may not be an actual breach of a warranty since the warranties are linked to “substitute checks.” In short, we recommend that the Act be amended so that all of the duties, obligations and protections that arise under the Act apply to “substitute checks” as defined and to items which are presented and handled with the intent that they be treated as substitute checks under the Act.

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<sup>1</sup> The legal equivalency protections of Section 3(b) rely not only on an item being a “substitute check;” the item must also meet two additional tests in order to gain these protections—be an accurate representation of the truncated original and bear a certain legend. While we understand the theory behind the accurate representation requirement, we are concerned that a court may hold that the original check must be presented to be able to determine if the substitute check “accurately represents” the original check at the time of truncation. We also believe that the bank should have an affirmative obligation to affix the Section 3(b)(2) legend on the substitute check.

## **Inclusion of Electronic Check Images**

Electronic images of original checks were included within the scope of the Act during the drafting stage, but were subsequently omitted.<sup>2</sup> The Federal Reserve's section-by-section analysis of the revised version submitted to Congress stated that the Federal Reserve favors excluding electronic checks from the proposed Act's scope because that would allow "the banking industry to address liability and technical issues related to electronic exchanges through agreements" which the Federal Reserve believes is preferable. However, while such agreements can successfully address many liability and technical issues, they cannot solve issues surrounding the "legal equivalency" of electronic check images. For this reason, AFP recommends that electronic images of checks be included in coverage under the Act in so far as their legal equivalency is concerned.

As the Federal Reserve points out, banks today exchange electronic check information and images under bilateral or multilateral agreements with each other and by agreement with their customers, including many major companies. This may be an agreement between banks engaging in electronic presentment of check images or information describing checks under U.C.C. Section 4-110(a), or an agreement between a bank and its customer providing that, regardless of whether original checks or images are presented for payment, only images will be supplied to the customer under Section 4-406(b).

However, companies that receive electronic images of checks are not "in the substantially equivalent legal and practical position regardless of whether or not they received the original check," which is one of the Federal Reserve's stated objectives in promoting Check 21. If companies continue to be exposed to legal uncertainties regarding the acceptability of electronic check images in a court of law, their acceptance and use of electronics in the check clearing process will be undermined and the Federal Reserve's efforts to facilitate check truncation and foster innovation would be considerably hampered.

The original draft produced by the Federal Reserve solved this problem by providing legal equivalency for "electronic checks," meaning both images of original checks that passed normally through the collection chain and the new form of substitute checks. With the omission from the scope of the Act of provisions relating to electronic checks, there can be no assurance that electronic images would not be precluded from acceptance in court under state evidence laws. Such preclusion could bar an attempt by a payor to prove payment by the introduction of the image of a truncated check or by a payee to prove that a truncated check was returned by the payor bank.

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<sup>2</sup> The Federal Reserve's original February 2001 draft used the term "electronic check" throughout the text, and it was defined as meaning "a digitized reproduction of an original check or a substitute check."

AFP is concerned that the Uniform Electronic Transactions Act (UETA) and the federal E-Sign Act do not definitively provide that electronic check images satisfy the various state rules of evidence in cases of contract disputes where payments are involved. Those Acts state that if a statute, regulation, or other rule of law requires the retention of a check, that requirement can be satisfied by retaining an electronic record.<sup>3</sup> Both laws also state, however, that their respective terms do not apply to transactions governed by, among other things, Articles 3 and 4 of the U.C.C. on check processing.<sup>4</sup> As the Federal Reserve affirmed in its analysis of the Act, “both E-Sign and UETA by their terms affect only rules requiring the retention of paid checks, such as for recordkeeping or audit purposes, and do not create electronic or substitute payment instruments.”

In a payment dispute, a party may object to an electronic image of a paid, original check and claim that E-Sign may not be relied upon for its introduction since there is no law at issue which requires the retention of the check for such purposes. By firmly stating the legal equivalency doctrine for all check images here, as was done in the original draft, a bank customer is not left to the vagaries of state laws and evidence rules for whether an image of a check sent to it by its bank may be used for all purposes.

#### Benefits of legal equivalency for “electronic checks”

To close this gap and clarify check law as it applies to truncation, AFP recommends the limited reintroduction to the Act of legal equivalency protections for “electronic checks.” This will eliminate the legal uncertainty to which companies involved in contract disputes may be exposed, enable banks and their customers who receive electronic images “to be in substantially the same legal and practical position regardless of whether or not they received the original check,” and promote the acceptance of check truncation. The Federal Reserve states that today less than one-quarter of checks are presented electronically. Much work needs to be done to increase that number. Eliminating the legal uncertainty surrounding electronic images will speed that effort, especially among companies that write a significant volume of the nation’s checks. Such a limited reintroduction furthers the Act’s purposes without changing any existing laws, for example, surrounding warranties and recrediting rights for such items, which are adequately addressed under U.C.C. Articles 3 and 4 and need only be covered in the Act for the new class of “substitute checks.”

#### **Other Drafting Issues**

Section 12 broadly provides that only Section 7 may be varied by agreement. While this should be sufficient to avoid a disclaimer of the warranties, indemnities and other protections of Sections 4 and 5, typically such provisions expressly provide that their terms cannot be

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<sup>3</sup> For example, see Section 101(d)(4) of E-Sign.

<sup>4</sup> For example, see Section 103(a)(3) of E-Sign.

disclaimed. For example, the various check warranties and corresponding indemnities contained in U.C.C. Sections 3-416, 3-417, 4-207 and 4-208 all provide that their provisions “cannot be disclaimed with respect to checks . . . .” In the interest of not drawing any unfavorable inferences by excluding such a provision from this Act, we recommend that similar language be added.

Finally, H.R. 5414, as reported, does not appear to contain an actual definition of “customer” in Section 2(10). The term is used extensively in Section 10 regarding the Federal Reserve’s duty to prepare an educational document on substitute checks and banks’ duties to distribute the document to “each existing and potential customer of the bank” (emphasis added). We are unclear whether commercial and consumer customers are intended to be covered or just consumer customers.<sup>5</sup> At a minimum, it would make sense to limit coverage to existing and new (as opposed to “potential”) customers with accounts that can be accessed by checks. Since much of a bank’s compliance costs are passed on to its customers, at least indirectly, we do not believe that an overly broad notice requirement is in the public’s interest.

## **Recommendations**

AFP supports legislation that would improve the efficiency of the payments system and facilitate check truncation by authorizing substitute checks as the legal equivalent of the original check. We urge the House to improve the Check 21 Act by:

- Extending the duties, obligations, and protections of the Act to items which are processed as substitute checks even if they do not meet all of the Act’s technical requirements;
- Including electronic images of checks within the scope of the Act for purposes of legal equivalency, in order to eliminate uncertainty regarding the acceptability of electronic check images in contract disputes where payments are involved and thereby to advance the adoption of electronics in check processing; and
- Clarifying certain other drafting issues.

The Association thanks the Subcommittee for this opportunity to comment on the Check 21 Act.

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<sup>5</sup> We note that the document is required to discuss, among other topics, the protections of Section 6 that apply only to consumers.